Jean-Claude Trichet: Testimony before the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, Brussels, 23 May 2005.

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Madame la Présidente, Mesdames et Messieurs les Membres de la Commission Economique et Monétaire, je me réjouis de paraître devant votre Commission aujourd'hui et de poursuivre ainsi notre dialogue régulier. Vous connaissez le rôle important que jouent nos rencontres trimestrielles dans le contexte de la responsabilité de la Banque Centrale Européenne vis-à-vis nos citoyens, responsabilité à laquelle, comme vous le savez, la BCE attache beaucoup d'importance. Je commencerai mon discours avec une évaluation de la situation économique et monétaire. Aus Anlass des unlängst erfolgten Beitrittes von drei neuen Mitgliedstaaten zum Wechselkursmechanismus II möchte ich sodann auch kurz zu diesem Thema Stellung nehmen.

Economic and monetary developments

Recent data confirm that some of the downward risks to economic growth identified in the past, in particular those related to persistently high oil prices, have partially materialised over the last few months. According to Eurostat's flash estimate, real GDP rose by 0.5% quarter on quarter in the first quarter of 2005. While this compares favourably with the 0.2% increase observed in the previous quarter, the apparent improvement largely reflects technical factors related to working day adjustments to the data. Taking those factors into account, the recent available indicators of economic activity suggest that the modest growth observed in the second half of 2004 will continue in the first half of 2005, with no clear signs as yet of a broadening or strengthening of the growth dynamic.

Looking further ahead, investment is expected to continue to benefit from robust earnings, improvements in business efficiency and very favourable financing conditions. On the external side, euro area exports should continue to benefit from global economic growth. Accordingly, we expect continued, relatively moderate economic growth in the euro area in 2005 and 2006. This picture is broadly in line with available forecasts from international and private sector organisations.

The outlook for economic activity continues, however, to be surrounded by relatively high uncertainty. On the domestic side, uncertainties relate in particular to the evolution of private consumption in relation with consumer confidence. On the external side, persistently high oil prices and continued global imbalances pose downside risks to growth. With regard to those global imbalances, let me note that I fully trust that they can be progressively alleviated only by embarking actively on the homework that has to be done in all G-7/G-3 economies, in particular by correcting the lack of savings in the US and implementing structural reforms in Europe.

Let me add that the ECB is also of the view – and I have signed myself the G-7 communiqués since the meeting in Boca Raton, at the beginning of last year, that are stressing this point – that the currencies of a number of Asian emerging countries are undervalued against major international currencies, in particular the euro and the dollar. This is the case of the Chinese currency, but not only of the Chinese currency.

Turning to price developments in the euro area, according to Eurostat, annual HICP inflation was 2.1% in April, unchanged from the previous two months. Over the coming months, annual HICP inflation rates are likely to remain around current levels, partly reflecting upward pressure on energy prices stemming from oil price increases. As regards the labour market, wage increases have remained contained over recent quarters and, in the context of moderate economic growth and weak labour markets, this trend should continue for the time being. Overall, we continue to see no significant evidence of underlying domestic inflationary pressures building up in the euro area. This picture is broadly in line with forecasts recently released by international and private sector organisations.

However, there continue to be upside risks to price stability over the medium term and these risks warrant continued vigilance. Risks are associated mainly with oil price developments and potential second-round effects stemming from wage and price-setting behaviour. In this respect, responsibility on the part of social partners remains very important.

Our monetary analysis also calls for vigilance regarding upside risks to price stability over the medium to longer term. After moderating in the first half of 2004, monetary and credit growth remain strong, reflecting the stimulative effect on monetary dynamics of the historically very low level of interest rates in the euro area. As monetary dynamics over the past year have mainly been driven by developments in the most liquid components of M3, this continues to signal upside risks to price stability in the medium to longer term. Moreover, strong monetary and credit growth – in particular the marked growth observed in loans for house purchase – require careful monitoring.

In the context of relatively contained underlying inflationary pressures, the ECB has left its key interest rates unchanged since June 2003. The low level of nominal and real interest rates has provided significant and continued support to the economic recovery. At the same time, upside risks to price stability need to be monitored closely. Cross-checking with the indications from the monetary analysis supports the case for continued vigilance with regard to those risks.

Monetary policy and heterogeneity

I would like to make some remarks on inflation and growth disparities in the euro area and how they may be relevant for the conduct of monetary policy.

Inflation dispersion in the euro area declined throughout the 1990s. Since the introduction of the euro it has broadly stabilised at a low level similar to those observed in other long-standing monetary unions, such as the United States. Over the same period, the dispersion in real economic growth has been in line with its historical values. Although dispersion has increased somewhat in the last few quarters, particularly as regards the four largest euro area economies, it does not appear exceptional from a historical perspective.

Differentials in growth and inflation across regions and sectors are a standard feature of vast currency areas around the world. They are a natural product of the continuous readjustment of relative prices and quantities in a market economy.

At the same time, the persistence of differentials across the euro area is a matter that needs to be addressed. To some extent, this is a reflection of deep-seated structural inefficiencies, such as nominal and real rigidities in labour and product markets. Such structural differences call for appropriate national policies with a view to achieving a higher degree of flexibility and adaptability in the institutions and market structures of all economies.

In line with its mandate, as laid down in the Treaty, the ECB focuses on maintaining price stability in the euro area as a whole. The ECB's internal work, analysis and assessment of economic information, its policy discussions and its deliberations are directed at achieving its primary objective for the entire currency union. While limiting inflation and growth differentials cannot form an objective for the ECB's monetary policy, it is necessary for the ECB to assess the underlying causes of such differentials. Monitoring national and sectoral developments is key to understanding the underlying trends in the euro area as a whole with a view to formulating the most appropriate monetary policy response. Consequently, the ECB regularly reviews and analyses all relevant information relating to the various sectors and countries of the euro area. In this respect, particular attention must be given by responsible authorities to the evolution of competitiveness indicators, in particular of unit labour costs in the various national economies. These indicators are key in a single currency area where realignments are excluded by definition.

The ECB's quantitative definition of price stability, its high degree of credibility and its focus on the achievement of its primary objective have enabled it to control inflation and to anchor inflation expectations in the euro area at a very low level in all countries of the euro area. This has resulted in low interest rates and extremely favourable financing conditions to the benefit of all euro area economies. Moreover, by anchoring inflation expectations and increasing transparency, monetary policy contributes to the adjustment of relative prices and facilitates the role of such prices in guiding the allocation of resources across countries and sectors. This is the best contribution that monetary policy can make to economic welfare and the achievement of high levels of activity and employment in our economies.

Fiscal policies and the Stability and Growth Pact

Let me now turn to fiscal policies. While a few countries succeed in maintaining sound budgetary positions, developments in many euro area Member States remain disappointing. Unless additional measures are taken, it is looking increasingly unlikely that those countries will reduce their deficits this year below the reference value of 3% of GDP or prevent them from exceeding that level. In the meantime, the indebtedness of euro area governments as a percentage of GDP has again increased.

It is therefore essential that consolidation be given the highest priority in the countries concerned and that the reformed Stability and Growth Pact be implemented in a strict and timely manner to ensure a rapid return to sound budgetary positions. This is primarily in the interests of the countries themselves, especially in view of the increasing pressure being placed on government budgets by ageing populations.

Lisbon Strategy

I would also like to take this opportunity to stress again the need to implement structural reforms in Europe. These reforms should be aimed at realising a more dynamic and competitive economy with flexible labour, product and financial markets, allowing for a more rapid adjustment of production factors to a constantly changing environment. We are faced with the unavoidable challenges arising from an ongoing deepening in the global division of labour, a fast process of technological change and the ageing of the European population. The appropriate response is to create the conditions which will allow both firms and workers to deal with these challenges in the most effective and efficient manner, thereby ensuring a high level of output growth and job creation in the longer run.

The recent relaunch of the Lisbon Strategy at the spring European Council meeting has rightly refocused policy priorities on the drivers of growth and employment. This needs a strong commitment to well-designed and comprehensive structural reforms, the benefits of which are efficiently explained to the public opinion. By undertaking the measures and convincing the public in this way Europe will succeed in both improving the economic outlook and sustaining the welfare and prosperity of European citizens.

The Exchange Rate Mechanism II

A little more than a year has now elapsed since ten new Member States joined the European Union, and their economic integration has been progressing at an impressive pace for a number of years. A number of these countries have also advanced significantly in terms of monetary integration. With effect from 2 May 2005 Cyprus, Latvia and Malta joined the Exchange Rate Mechanism II (ERM II), bringing the number of countries participating in ERM II to seven. Indeed, Estonia, Lithuania and Slovenia had already decided – in June of last year – to join Denmark in ERM II. The inclusion of the new currencies in the mechanism has proceeded in a very smooth and orderly manner.

With their entry into ERM II, these countries have linked their currencies to the euro as a preparatory step towards the ultimate adoption of the single currency. Being members of ERM II will help them to orient their policies towards stability. Indeed, as was stressed in the 1997 Amsterdam Resolution of the European Council on ERM II, the mechanism has been designed as a reference for the conduct of sound economic policies in general and monetary policy in particular. Thus, the mechanism should also contribute to the achievement of sustainable convergence.

However, membership of ERM II will not automatically yield sound policies. Rather, successful and smooth participation in the mechanism requires significant commitments of the part of its members. Although the precise nature of these commitments depends on the specific situations in the various participating countries, I would like to stress in this context the importance of pursuing sound fiscal policies and a stability-oriented monetary policy, as well as measures to enhance the flexibility and adaptability of the economy. The pursuit of such policies within the ERM II framework will not only be of direct benefit to the Member States concerned, but will also help to ensure the smooth functioning of the system as a whole.

In conclusion, membership of ERM II for a period of at least two years and without severe tensions prior to the convergence examination is a crucial element on the road to the adoption of the euro. This is not only a phase which tests Member States' eligibility to adopt the euro, but also serves those Member States' own best interests. I should like to add that each individual Member State's date of entry and period of participation in the mechanism depends on its specific situation. The ECB as well as the Commission will continue to carefully monitor exchange rate developments within ERM II, together with the other convergence criteria, and will present their conclusions in the Convergence Reports, in line with the provisions of the Treaty.

I am now at your disposal for questions.