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

Testimony by Mr Jean-Claude Trichet, President of the European Central Bank, at the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 10 October 2006.

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Madame la présidente, Mesdames et Messieurs les membres de la Commission économique et monétaire, je me réjouis de paraître devant votre Commission aujourd'hui et de poursuivre ainsi notre dialogue régulier. Nos rencontres trimestrielles sont très importantes pour la Banque centrale européenne, comme vous le savez. Je commencerai mon intervention par une évaluation de la situation économique et monétaire.

Besonderes Augenmerk möchte ich anschließend auf die Notwendigkeit umfassender Strukturreformen im Euroraum legen. Auch möchte ich auf divergierende Entwicklungen in der Wettbewerbsfähigkeit einzelner Mitgliedsländer des Euroraums in Bezug auf Preise und Kosten näher eingehen.

Economic and monetary issues

On the occasion of my previous appearance before the European Parliament in June, I described how the new data at that time confirmed our assessment that economic growth in the euro area was broadening and becoming more sustained. In addition, the cross-checking of our economic and monetary analyses underlined the prevalence of upside risks to price stability over the medium to longer term. In order to contain upside risks to price stability and preserve the firm anchoring of inflation expectations, the Governing Council of the ECB has continued to progressively withdraw monetary accommodation, increasing key ECB interest rates by 25 basis points on 3 August and again earlier this month. Let me explain in more detail the assessment underlying these decisions and the outlook for the economy and risks to price stability.

Starting with the economic analysis, all the main indicators of economic activity that have become available over the past few months confirm that the economic recovery has become more broadly based and is mainly supported by domestic demand. All in all, the recovery appears to be somewhat stronger than on the basis of earlier data. Notably, the strong data on real GDP growth in the euro area has confirmed that a significant acceleration in economic expansion has taken place over the past few quarters. With the quarter-on-quarter growth rate of real GDP at 0.9% for the second quarter of 2006 and on the basis of upward revisions to the real GDP growth data for the two preceding quarters, economic activity has been growing robustly, at a quarterly rate of around 0.7% on average over the last four quarters. In addition, the unemployment rate has been on a falling trend, employment growth has recovered and employment expectations have remained favourable. The incoming information on activity in the third quarter further supports the assessment that economic activity will continue to grow robustly, while possibly moderating somewhat.

Looking ahead to the remainder of 2006 and 2007, the conditions remain in place for the euro area economy to grow at solid rates around potential, with some volatility in the quarterly growth rates likely to emerge around the turn of the year. Global economic activity has become more balanced across regions and is still robust, thereby providing ongoing support for euro area exports. Investment is expected to remain strong, benefiting from an extended period of very favourable financing conditions, balance sheet restructuring, accumulated and ongoing strong earnings, and gains in business efficiency. Consumption growth in the euro area should also strengthen further over time, in line with developments in real disposable income, as employment conditions continue to improve. This outlook was already embodied in the ECB staff macroeconomic projections of September, which for the first time included Slovenia as part of the euro area in the projections for 2007.

In the view of the Governing Council, risks to the outlook for economic growth are broadly balanced over the shorter term, although the recent fall in oil prices – if it were to prove lasting – has the potential to lead to somewhat stronger demand and output growth than embodied in the Governing Council's baseline scenario for activity in the coming quarters. Over the longer term, risks to growth lie on balance on the downside, and relate mainly to the possibility of renewed oil price increases, further protectionist pressures and disorderly developments owing to global imbalances.

Turning to price developments, annual HICP inflation rates have declined somewhat over the last few months, standing below 2% in September and mainly reflecting favourable base effects combined with the recent significant fall in oil prices. However, although the outlook for energy prices is uncertain, also taking into account current energy prices and the higher quotations on futures markets, headline inflation rates are likely to increase again towards the end of the year and in early 2007. As a consequence, the Governing Council expects a considerable degree of short-term volatility in the annual HICP inflation rate. Overall, the headline inflation rate will remain elevated at levels above 2% on average in 2006 and is likely to remain so in 2007, as it was also reflected in the ECB staff projections of September.

In the view of the Governing Council, risks to the outlook for price developments remain clearly on the upside. They include a stronger pass-through of past oil price rises into consumer prices than currently anticipated, additional increases in administered prices and indirect taxes beyond those announced thus far, and the possibility of renewed increases in oil prices. More fundamentally, given the favourable momentum of real GDP growth observed over the past few quarters and the positive signs from labour markets, stronger than currently expected wage developments pose substantial upward risks to price stability. Against this background, it is crucial that the social partners continue to meet their responsibilities, in particular in the context of a more favourable environment for economic activity and employment.

As regards medium to longer-term prospects for price developments, the monetary analysis continues to point to upside risks to price stability. The rate of monetary and credit expansion remains rapid, reflecting the still low level of interest rates in the euro area. In particular, loans to the private sector continue to grow at double-digit rates on an annual basis. From a medium-term perspective, these developments remain consistent with the persistent upward trend in the underlying rate of monetary expansion identified by the ECB’s monetary analysis since mid-2004. Moreover, following several years of robust monetary growth, the liquidity situation in the euro area continues to be ample by all plausible measures. Given the implied upside risks to price stability over the medium to longer term, monetary developments require careful monitoring, particularly against the background of improved economic conditions and strong property market developments in many parts of the euro area.

To sum up, annual HICP inflation rates are projected to remain elevated in 2006 and 2007, with risks to this outlook remaining clearly on the upside. Given the ongoing dynamism of monetary and credit growth in an environment of ample liquidity, cross-checking our monetary and economic analyses supports the assessment that upside risks to price stability prevail over the medium term.

It is against this background that the Governing Council of the ECB decided to further raise key ECB interest rates in two quarter-percentage increments on 3 August and 5 October to establish the minimum bid rate of the main refinancing operations of the Eurosystem at 3.25%. These actions have helped to keep inflation expectations solidly anchored at levels consistent with price stability. Such anchoring is a prerequisite for monetary policy to make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area. Notwithstanding recent increases in key ECB interest rates, our monetary policy in the euro area remains accommodative. If the Governing Council’s assumptions and baseline scenario are confirmed, it will remain warranted to further withdraw monetary accommodation. The Governing Council will therefore continue to monitor very closely all developments so as to ensure price stability over the medium and longer term.

Structural reforms

Fiscal consolidation – which is absolutely of the essence in the euro area – is likely to be most successful when coupled with comprehensive structural reforms. These are urgently needed not only to cope with the challenges posed by technological change and accelerating globalisation but in particular also to help to cushion the adverse economic effects of the projected demographic change in the euro area.

For Europe’s future in the face of these challenges, and for the prosperity of its citizens, it is essential to ensure that a fully operational Internal Market is up and running. This necessitates the fully free flow of labour and capital and free trade in goods and services. It also calls for continuing to fully implement the single market and removing the remaining barriers to it within the EU; this will provide a powerful means to promoting the efficient allocation of factors of production as well as deeper economic and financial integration. It will also allow Europe to better realise its potential for stronger output and employment growth and increase its resilience to shocks.

For those Member States that have fulfilled the convergence criteria laid down by the Treaty and participate in the euro area, the considerable benefits of the Internal Market are further enhanced by the single currency. I welcome the enlargement of the euro area on 1 January 2007 with the entry of Slovenia. In order to fully reap the advantages of the euro and to allow adjustment mechanisms to operate efficiently within the enlarged currency area, it will be necessary to fully integrate Slovenia into Economic and Monetary Union, including the free circulation of labour inside the euro area.

As regards the projected demographic dynamics for the euro area, the decline in the working age population and steadily increasing proportion of older people in the population will place further pressure on pension and health care systems, and may have wide-ranging economic consequences. In particular, without effective measures to raise labour supply and labour productivity growth, the potential economic growth rate of the euro area is set to decline. In order to support the potential economic growth of the euro area, to foster macroeconomic flexibility and dynamism, and to safeguard the future standard of living of our citizens, labour and product market reforms are urgently needed. This will increase labour market participation and employment, foster an attractive environment for investment and innovation, help to promote flexibility in wages and prices and strengthen all the other forces driving productivity and economic growth. The ECB will play its part by continuing to gear its monetary policy decisions in an unambiguous manner towards the maintenance of price stability.

Diverging competitiveness developments in the euro area

While pursuing the aforementioned structural reforms is essential to maintain the competitiveness of the euro area as a whole and to translate the opportunities brought about by globalisation into achievements, there is also a need to address deviating trends in competitiveness within the euro area.

Competitiveness is commonly understood as the ability of a country to compete in international markets. This ability is usually assessed on the basis of various measures of cost and price competitiveness and complemented by accounting for “non-price” factors, such as the quality and the technology content of the goods produced, the ability to diversify and innovate quickly, the reliability of the servicing network. Ideally, one should look at all these measures to fully understand the direction in which a country is moving. However, I will limit my considerations to relative developments in cost and price developments across euro area countries.

The analysis of cost and price competitiveness across a wide range of indicators suggests that euro area countries have experienced rather diverse competitiveness trends since the start of the EMU.

Persistent losses in cost and price competitiveness – if those are not offset by corresponding improvements in non-price competitiveness – are sooner or later paid in terms of output losses, rising unemployment and increasing current account deficits. These losses in cost and price competitiveness mainly originate from a lack of flexibility in labour and product markets and reflect the need to improve the adjustment capacity of the economies concerned. Indeed, structural rigidities – and in particular distortions in the wage and price formation mechanism – hinder a proper working of the competitiveness adjustment mechanism across the euro area countries.

Let me stress further this point. By looking behind unit labour costs developments in the countries where they have been rising persistently, it appears that these losses mainly reflect a slowdown in labour productivity growth and a failure to keep wage growth in line with productivity developments. Clearly, this suggests that the process of wage determination in some euro area countries should allow for sufficient differentiation in order to give greater regard to the situation in individual firms, industries, sectors or regions and take account of labour market conditions. In other words, when deciding on how to compensate productive factors, and in particular employees, the social partners involved need to take into account the efficiency in producing output and also they need to internalise the repercussions of wage settlements on the competitiveness of the firm, industry, sector or region. Indeed, experience shows that in countries where social partners have taken into account the implications of their wage settlement decisions on competitiveness, the European and global market shares of their exports have been more resilient and job creation more dynamic.

This is why structural reforms are crucial in the areas of tax and benefit systems, wage-setting mechanisms, including wage indexation, and labour legislation. In general, policies to foster a sufficient degree of competition in the labour, goods, services and capital markets, to create a business-friendly environment for investment and innovation and a high degree of wage and price flexibility need to be given priority in the agenda of the national policy makers. These reforms would help to encourage better allocation of resources, improving the efficiency of investment decisions as well as increasing productivity and real GDP growth.

Let me stress, in conclusion, that the European Central Bank backs the drive towards reforms that is in motion in Europe. The European Central Bank backs the Governments of Europe that are embarking courageously on those structural reforms. We do not underestimate the difficulties of the task and the necessity to explain tirelessly that the people of Europe will be better off thanks to these reforms.

I thank you for your attention.