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, 20 December 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. Je commencerai mon intervention par une évaluation de la situation économique et monétaire.

Anschließend möchte ich auf zwei Themen näher eingehen: Erstens, auf den Zusammenhang zwischen Produktivität, Potentialwachstum and Geldpolitik. Zweitens, auf das Geldmengenwachstum in verschiedenen Abgrenzungen und dessen Einfluss auf das Preisgeschehen.

Economic and monetary issues

At the time of my previous appearance before the European Parliament in October, I described how the data then available had served to confirm our assessment that economic growth in the euro area was becoming more broadly based and increasingly supported by domestic demand. In addition, the cross-checking of our economic and monetary analyses underlined the existence of upside risks to price stability over the medium to longer term. In order to contain such upside risks to price stability and preserve the firm anchoring of longer-term inflation expectations, on 7 December the Governing Council of the ECB decided to increase key ECB interest rates by 25 basis points. Let me explain the assessment underlying this decision and the outlook for the economy and risks to price stability.

Starting with the economic analysis, the main indicators of economic activity that have become available over the past few months confirm the Governing Council's assessment that economic activity has continued to expand robustly, albeit moderating somewhat from the very strong rates seen in the first half of the year. According to Eurostat's first estimate, the quarter-on-quarter growth rate of real GDP in the euro area for the third quarter of 2006 was 0.5%, driven mainly by domestic demand. This confirms the anticipated broadening of the recovery and points to the increasingly self-sustaining nature of economic expansion in the euro area. This assessment is also in line with available information for the fourth quarter.

Looking ahead to next year, the conditions remain in place for the euro area economy to grow solidly at rates around potential, with some volatility in the quarterly growth rates likely to emerge around the turn of the year on account of the impact of changes in indirect taxes in a large euro area country. Overall, global growth has become geographically more balanced and remains robust, providing support for euro area exports. Investment is expected to remain dynamic, benefiting from an extended period of very favourable financing conditions, balance sheet restructuring, accumulated and ongoing strong earnings, and gains in business efficiency. Consumption should also strengthen further over time as employment conditions continue to improve. This outlook for economic developments is reflected in the new Eurosystem staff macroeconomic projections (2.5 % to 2.9 % in 2006, 1.7 % to 2.7 % in 2007, 1.8 % to 2.8 % in 2008) and is also in line with recent forecasts made by international organisations.

The risks surrounding the outlook of sustained economic growth close to potential lie on the downside and relate mainly to the possibility of a renewed increase in oil prices, fears of a rise in protectionist pressures, and concerns about possible disorderly developments owing to global imbalances.

Turning to the price developments, annual HICP inflation rose to 1.9% in November 2006, from 1.6% in October. The lower annual HICP inflation rates recorded in the previous months mainly reflected the significant declines in crude oil prices from August onwards, as well as base effects. While the outlook for energy prices remains uncertain, overall inflation rates are likely to increase again in early 2007 and then hover around 2% in the course of that year and in 2008, also reflecting the impact of higher indirect taxes. The Eurosystem staff projections point to a rate of inflation of 2.1 % to 2.3 % in 2006, 1.5 % to 2.5 % in 2007 and 1.3 % to 2.5 % in 2008.

This outlook for price developments remains subject to upside risks, stemming in particular from a stronger than expected pass-through of previous oil price increases, as well as the possibility of renewed oil price increases and of additional increases in administered prices and indirect taxes beyond those announced and decided thus far. More fundamentally, given the favourable momentum of real GDP growth observed over the past few quarters and the positive signs from labour markets, wage developments could be stronger than currently expected.

Turning to developments in the monetary aggregates and credit, annual M3 growth was unchanged at 8.5% in October, remaining close to the highest rates observed since the introduction of the euro. Increasing interest rates have exerted some influence over monetary developments in recent months, although as yet mainly by triggering shifts among the components of M3 rather than constraining the expansion of M3 itself.

Taking the appropriate medium to longer-term perspective, the latest developments are consistent with a continuation of the persistent upward trend in the underlying rate of monetary expansion, identified by the ECB's monetary analysis since mid-2004. Furthermore, following several years of robust monetary growth, the liquidity situation in the euro area is ample by all plausible measures. Continued strong monetary and credit growth in an environment of ample liquidity point to upside risks to price stability over the medium to longer term. Monetary developments therefore continue to require very careful monitoring, particularly against the background of improved economic conditions and continued strong property market developments in many parts of the euro area.

To sum up, annual inflation rates are projected to hover around 2% in the coming two years, with risks to this outlook remaining on the upside. In addition, given the ongoing strength of monetary and credit growth in an environment of ample liquidity, a cross-check of the outcome of the economic analysis with that of the monetary analysis supports the assessment that upside risks to price stability prevail over the medium to long term.

As I said on December 7, our decision to increase key ECB interest rates by 25 basis points on 7 December contributes to ensuring that medium to longer-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability, which is a prerequisite for monetary policy to make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area. Indeed, acting in a firm and timely manner to ensure price stability in the medium term is warranted. The Governing Council will therefore monitor very closely all developments so that risks to price stability over the medium term do not materialise.

As regards fiscal policy, the Commission's autumn forecasts point to improving fiscal balances, but this can only partly be attributed to progress in structural consolidation, as higher economic growth and revenue windfalls are playing an important role. Moreover, in a number of countries with fiscal imbalances, adjustment efforts still fall short of what is needed to meet their respective medium-term objectives in a timely manner. It is therefore crucial that forthcoming updates of the stability programmes make sufficient headway towards safe budgetary positions in the countries concerned. For all countries it is paramount that pro-cyclical policies be avoided in the current economic upswing.

Productivity, growth potential and monetary policy

Over the last fifteen years the euro area has witnessed an almost steady deceleration in the growth rate of labour productivity. This deceleration can be explained by underlying developments, some of which are welcome, whereas others are less favourable. First, it is the effect of some welcome progress in labour market reforms and wage moderation over the last decade. Although it is seldom stressed in public discourses, these measures have contributed to remarkable results. Over the last eight years (the period in which the single monetary policy has been in place), employment has risen by 9.2 percentage points and the unemployment rate has declined by 1.9 percentage points. Let me also stress that if I compare the 8 years after the euro was set up with the 8 years before the euro, we created 11.73 million jobs after the euro and only 2.65 million jobs before the euro. Second, and less welcome, the decline in productivity is partly the result of capital investments not keeping up with the pace of job creation. The still existing rigidities in product and labour markets that impair effective competition and flexibility, and more generally the presence of regulatory restraints on business, have prevented firms from investing more strongly in the adoption of new information and communication technologies, which could be effective tools to reduce costs and improve productivity.

Ultimately, the growth rate of the actively working population and the pace at which technological progress is implemented in the production process are the critical determinants of the growth rate of

potential output. It is extremely important, especially at this juncture, to strengthen the reforms aimed at increasing employment, fostering competition in the product markets and creating an environment favourable to the development and implementation of new concepts and technologies. All individuals need to have the opportunity to get appropriate training. In a knowledge economy the wealth and prosperity of European citizens depend on their education, training and skills and the extent to which these skills can flourish in a flexible economy open to innovation and change.

There are sometimes calls upon the central bank for more expansionary monetary policy as an incentive to increase productivity. I shall make two points on this. First, monetary policy cannot enhance the trend growth rate of productivity and potential output. A loose monetary policy would just create high inflation and inject volatility into the economy. On the contrary, a monetary policy geared to delivering low and stable inflation contributes to creating a favourable macroeconomic environment for employment creation and investment decisions. Price stability reduces interest rate premia, and thus the cost of capital, and allows wage and price-setters to focus on productivity, costs and competitive factors, rather than wasting resources on protecting themselves against uncertainty about future inflation. Second, the negative productivity developments I have just discussed have not only been a drag on economic activity, they have also put significant temporary upward pressure on inflation, especially after 2001. The increase of unit labour costs due to mediocre productivity, combined with other supply shocks such as oil price increases, have contributed to a level of inflation over the threshold of our definition of price stability of less than 2%. Had we not had a highly credible monetary policy, we would not have been able to anchor solidly medium and long-term inflationary expectations in the euro area and we would have had to pay a significant price in terms of growth and job creation.

Developments in monetary aggregates and their impact on inflation

Let me now turn to the important role played by the monetary analysis in the ECB's monetary policy strategy and interest rate decisions. As you know, we are cross-checking the results of our economic analysis with those of our monetary analysis. Allow me to recall that the strong long-term relationship between monetary growth and inflation is one of the best documented empirical findings in economic literature. Many studies have documented this relationship in the euro area, demonstrating that it is particularly close over longer horizons. I will add that the national currencies that had the highest level of credibility prior to the introduction of the euro and against which the Euro has been benchmarked, all relied on a monetary policy framework embodying a role for monetary analysis. Given the ECB's mandate to maintain price stability, the necessarily medium-term orientation of its strategy to do so and the continuity between the most credible national currencies and the Euro, assigning an important role to the analysis of monetary developments is both necessary and very useful. The monetary pillar of the ECB's monetary policy concept has contributed importantly to the success of our monetary policy and to the anchoring of long-term inflation expectations.

In recent years, money has grown strongly while, at the same time, inflation developments have remained under control. This begs the question of how the ECB has interpreted strong monetary growth. The ECB has always emphasised the broad-based nature of its monetary analysis. In order to distil the policy-relevant "signal" about risks to price stability from the monetary data, the inevitable "noise" in shorter-term movements needs to be identified and removed. To do so, the ECB employs a variety of instruments, such as analysis of the components and counterparts of money, and other economic and financial data as necessary, as well as statistical and econometric models.

The practical side of this signal extraction problem in the euro area can be illustrated by the experience between 2001 and 2003. Financial and geopolitical uncertainty at that time triggered portfolio shifts into safe and liquid monetary assets. Since these shifts reflected portfolio behaviour rather than an accumulation of transaction balances, the ensuing strong monetary expansion was assessed by the Governing Council not to pose risks to price stability under the prevailing economic conditions. On this basis, strong monetary growth of the M3 measure during that period was analysed as relatively benign in terms of inflationary risks, in line with the information extracted from the economic analysis.

This example illustrates how the ECB has eschewed a mechanical interpretation of the development of M3. Rather, the ECB has sought to explain monetary developments in a comprehensive manner, extract from these developments the policy-relevant signal about the medium to long-term outlook for inflation, and set interest rates in a manner that addresses the risks to price stability revealed by this analysis as well as by the complementary economic analysis.

Since mid-2004, monetary growth in the euro area has been of a different nature to that observed between 2001 and 2003. In particular, the strengthening of M3 growth has been driven by the low level of interest rates rather than portfolio shifts into money. This has been reflected in the strong contribution that the most liquid components, such as currency and overnight deposits, have made to M3 growth. Moreover, strong money growth has been primarily driven by a rapid expansion of loans to the private sector, underpinned by the economic recovery. Taking the appropriate medium- to longer-term perspective, the continued expansion of money and credit through the course of 2005 gave an intensifying indication of increasing risks to price stability, fully in line with the results of our economic analysis, and vindicating our orientation to progressively increase interest rates by 150 basis points from December 2005 onwards.

I thank you for your attention.